

**State Investment Commission
Minutes
December 21, 2004**

The State Investment Commission was called to order by Jonathan Miller, State Treasurer, on Tuesday, December 21, 2004 in Room 264 of the Capitol Annex at 1:00 p.m. Members present were Robbie Rudolph, Secretary, Finance and Administration Cabinet; Michael Adams, proxy for Governor Ernie Fletcher; and Jonathan Miller, State Treasurer.

Treasurer Miller verified that a quorum was present and that the press had been notified of the meeting.

A motion was made by Mr. Adams and seconded by Secretary Rudolph to approve the minutes of the September 22, meeting. Motion **CARRIED**.

Mr. Dwight Price, senior portfolio manager, Office of Financial Management, introduced Charles F. Bell, Jr., who will become the executive director of the Office of Financial Management on January 1, 2005. Mr. Price informed the Commission that the Office of Financial has undergone a reorganization that will create a Statewide Investment Accounting section. Mr. Price stated that interviews have been held to fill the recently established Staff Assistant position. Mr. Price indicated that in the past he has managed both the investment section and the accounting and that the Auditor's Office felt that those duties should be separated. Mr. Price continued that the staff assistant would manage the accounting section and leave him free to manage the portfolio. Mr. Price also indicated that an entry-level debt person would also be hired in the next few weeks.

Mr. Price informed the Commission that staff has issued a Request for Proposal ("RFP") for securities lending services. Mr. Price stated that securities are lent and cash is received and the Commonwealth in turn invests the cash. Mr. Price indicated that the Commonwealth uses a third-party lender rather than its custodial bank to lend its securities. Mr. Price indicated that the contract with the current securities lending provider, Credit Suisse First Boston, expires on January 31, 2004. Mr. Price informed the Commission that last year the Commonwealth made about \$2.4 million by lending its securities. The responses to the current RFP is due January 6, 2005. A committee will review the proposals and a decision will be made by the end of January.

Treasurer Miller asked what type of response was received from the RFP. Mr. Price indicated that the RFP was sent to most firms that are qualified to provide the services. Mr. Price indicated that about ten firms were sent the proposal and he expects about 6 responses to the RFP.

Mr. Steve Jones, portfolio manager, Office of Financial Management, discussed the year-to-date results of the TRAN. Mr. Jones stated that the Commonwealth issued approximately \$500,000,000 of Tax and Revenue Anticipation Notes were issued at a 1.55 percent yield and will mature in June 2005. Mr. Jones indicated that the proceeds from the TRAN were reinvested with the expectation of earning arbitrage to be returned to the General Fund. Mr. Jones stated that in order to accomplish that, the Commonwealth entered into an interest rate swap that receives a 2.23 percent fixed rate. Mr. Jones stated that the Commonwealth is paying floating rate on the swap and the

assets are invested at the floating rate. Mr. Jones indicated that to date the Commonwealth has earned \$3.4 million on the investments, paid out \$3.2 million on the swap for a net of \$81,075.75. Mr. Jones stated that he expected that by the end of the program the earnings would decrease to zero. Mr. Jones stated that the Office of Financial Management expects to earn a fee of \$250,000 on this transaction, which pays for the operating costs of the office and indicated that any excess after operating costs are paid is deposited to the General Fund. Mr. Jones stated that the second side of the transaction involves issuance of fixed rate debt and the fixed side of the interest rate swap. Mr. Jones indicated that debt expenses to date have been \$5.7 million. He further indicated that the Commonwealth has accrued \$4.3 million on the interest rate swap for a net income of approximately \$1.1 million. Mr. Jones indicated that he expects the net income to be approximately \$2.7 million by the end of the year.

Mr. Jones discussed Attachment D on the agenda. Mr. Jones informed the Commission members that staff has executed an interest rate straddle. Mr. Jones explained that a straddle is an investment strategy involving the purchase of a particular derivative security. Mr. Jones indicated that the Commonwealth purchased two call options on interest rates swaps. He continued that when volatility is low you receive little for selling the option back to the market. Mr. Jones indicated that staff purchased volatility with the straddle expecting that the Commonwealth could sell it at some point in the future. Mr. Jones indicated that the Commonwealth has purchased callable options on two very similar interest rates swaps (swaptions). Mr. Jones indicated that one of the swaps would pay a fixed rate and receive a floating rate. Mr. Jones indicated that the second swap would receive a fixed rate and pay a floating rate. He added that the option to enter into either of these interest rates swaps matures December 15, 2005. Mr. Jones stated that Goldman Sachs is the counterparty for the swap and the Commonwealth paid \$957,500,000 for the right to enter into the swap.

With no further business before the Commission, a motion was made by Mike Adams and seconded by Robbie Rudolph to adjourn the meeting.



Secretary
State Investment Commission